

It's Not Our Job to Time the Market

Stockholm (HedgeNordic) – Stockholm-based long/short equity fund **Elementa** enjoyed only positive months year-to-date, having gained 16.7 percent in the first four months of the year. Despite relying on a broad toolkit of instruments and an agile decision-making process, which affords the flexibility to add or mitigate risk as circumstances dictate, the team managing Elementa made no attempt to time the market during the turmoil unleashed by the coronavirus outbreak. “Our job is to build a robust portfolio that can hold out for a long time and that we can sit on for a long time,” portfolio co-manager Eric Andersson tells HedgeNordic. “It is not our job to time the market.”

Value-GARP Opportunities

Elementa employs a private equity-like research-intensive selection process to identify investment ideas in the Nordic small- and mid-cap space. “Elementa seeks to invest in growing high-quality companies at low valuations,” explains founder and CIO Marcus Wahlberg (*pictured*). “It sounds easy, but there is a lot of work behind the scenes.” These characteristics – quality, growth, and inexpensiveness – lead to “low operational and price risk in our investments,” according to Wahlberg. “You can notice that in the volatility of our returns.”

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Elaborating on the operational risk of Elementa’s long investments, Eric Andersson says that “we look for robustness in the business model to make sure there is no tail risk on the operational side.” Therefore, Elementa tends to invest in companies that run cash flow-generative businesses, enjoy structural growth, and have good management teams at the helm. “It is very seldom, however, that growing high-quality companies trade at reasonable valuations,” says Wahlberg. “Therefore, it is important to have a long-term perspective and look at the valuations 3-5 years from now, usually in combination with the company facing some kind of short-term headwinds or being in some kind of transformation.”



Portfolio co-manager Eric Andersson.

“In this kind of situations, these stocks may occasionally trade at significant discounts to their intrinsic value,” according to Andersson, who joined Elementa last year. “In the long run, beyond the

growth in top- and bottom-lines, you also enjoy multiple expansion,” explains the fund manager. “You have this double effect that can create good returns.” According to Wahlberg, who has been managing the fund since its inception in early 2015, “most of our best investments so far have been in some kind of transformation when we invested in them.” But no turnarounds, only minor transformations, emphasizes the founder.

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This contrarianism “means that we usually invest in companies with low valuations relative to their intrinsic value, to their potential,” explains Wahlberg. “Whereas some companies we invest in may trade at expensive multiples here and now, they have very low valuations relative to potential earnings five years ahead,” he elaborates. Despite having a long-term view, the team considers price risk the primary consideration in the portfolio construction process. “A high valuation, for example, also means that there are high expectations, which in turn means a lot of tail risk in the valuation of the company,” explains Andersson. “We need to consider whether this risk is acceptable both on a company level, but also on a portfolio level.”

Short Side

Elementa’s portfolio usually contains around 15 long positions and between 20 and 25 short positions. Whereas the long book mostly includes companies with tangible structural growth prospects, business model scalability and strong cash flow generation, the team at Elementa looks for the opposite when searching for short candidates. “The short positions are based on specific company characteristics,” which ensures that “there is a balance between the long side and short side” according to Wahlberg. “We group them based on different factors to have a balance, as we do not take on too much factor risk in our portfolio.”

According to Andersson, “the key characteristic of the short side is that we short companies with significant downside risk, where disruptions of any kind truly can create operational failure.” As Wahlberg elaborates, “we always try to short weak companies operating in deteriorating industries, as well as cyclical and volatile companies.” As “headwinds can rise from everywhere,” significant tail risk is a prerequisite for short candidates. “The first quarter of 2020 is a perfect example of that,” continues Andersson. “Most companies that truly got into trouble in the first quarter either faced operational headwinds or tried to maintain their business model in a deteriorating climate, or had high levels of debt that did not allow them to cope with external factors beyond their control.”

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Although Elementa mostly maintains short positions on individual securities, the team occasionally makes use of futures and options, predominantly on individual stocks. During the autumn of last year, for instance, Elementa piled up on cheap put options to bet against certain companies rather than add to their equity short positions. Because of the historically low implied volatility, Elementa managed to find an inexpensive way to benefit from falling share prices with limited downside risk. “We do not use options as a separate strategy,” says Wahlberg, who adds that “sometimes options are just a better way to do a short, either by limiting the downside or increasing the risk-reward ratio.” The basket of cheap put options was one of the three factors that contributed to Elementa’s strong performance so far in 2020.

2020 in Focus

"After several strong years behind us, more and more of our long positions have been hitting our targets," says Wahlberg. "It is natural for us to sell in that scenario, so our net exposure has been decreasing during the autumn and the beginning of 2020."

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As valuations were on the rise, "we were finding more and more attractive candidates for shorting," adds Wahlberg. The declining net exposure from the autumn of 2019 all the way to February "was a combination of selling longs and finding more shorts, as well as piling up on cheap put options." As the market went into freefall starting with late February and March, "the short positions were hitting our price targets" and the put options were expiring in the money, which led to an increase in Elementa's net market exposure.

"Purely mathematically, the short exposure decreases as the market falls since the portfolio weight of short positions decreases along with the falling market," explains Andersson. "It is natural that if our long side can hold, which it did during the period of plunging markets, our net exposure increases automatically," he adds. "We had very good alpha on the short side and alpha on the long side during the crash, hence our net exposure increased."

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After gaining about 11 percent in the first quarter, the higher net market exposure enabled Elementa to gain a further 5.1 percent in April as the markets witnessed a swift rebound. "The net exposure depends on the set of opportunities both on the long and short side," emphasizes Wahlberg. "We do not use net exposure as a way of seeking returns." As Andersson highlights, "we did not time the market and we did not play the crisis. It played itself."

Competitive Advantage

Maintaining a robust portfolio while heading into an unforeseen and unprecedented storm has made the Elementa team's lives easier. The team, however, did not sit idle. They never do. "We are really strong in the process of handling new information," emphasizes Wahlberg.

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"What we saw pretty early in the crisis was that the supply chain disruptions were going to hit some companies harder than others," says Andersson. "We had to go through the long side and see how this might affect the profitability of these companies." Whereas the long portfolio mostly remained intact after the review, the team increased some short positions to "capture the opportunity stemming from the supply chain disruptions."

During the volatile and turbulent first quarter, Wahlberg and his team at Elementa also took the opportunity to add new equity holdings to the portfolio, buy two undervalued bonds and participate in a directed share issue. "We have taken the opportunity to buy some companies at very cheap levels," says Andersson. However, "every single position must stand on its own and generate attractive returns on their own despite market moves."

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“Our way of handling the company selection and handling new information, which is a replicable and robust process,” represents a major strength of Elementa’s team. “It is our melody,” says Andersson. “We have no problems in changing our minds when new information comes in,” highlights Wahlberg.